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UNCLAS SECTION 01 OF 03 WARSAW 000253

SENSITIVE
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EUR FOR DAS GARBER, TOM YEAGER, JONATHAN KESSLER
STATE PLS PASS USTR FOR D. MULLANEY
NSC FOR KRISTINA KVIEN AND KATHERINE HELGERSON
TREASURY FOR STEVE WINN
COMMERCE FOR HILLEARY SMITH AND JAY BURGESS

E.O. 12958: N/A
TAGS: ECON EFIN PL
SUBJECT: POLAND'S ECONOMY HOLDS STEADY: FORTUNE FAVORS THE
PREPARED

REF: A. 08 WARSAW 1217
¶B. WARSAW 191

¶1. (SBU) Summary. Poland's economy is slowing amidst global weakness, but thanks to good timing and good policy, it is not in crisis. Poles are sheltering behind the prudent fiscal, monetary, and regulatory policy of recent years; the relative immaturity of Poland's consumer credit market; and a banking system (mostly populated by European and U.S. parent banks) focused on the meat-and-potatoes work of developing an young domestic market rather than the exotic "search for yield" of global financial markets in recent years. Importantly, Poland's economic cycle was reaching a peak as Lehman Brothers collapsed in September 2008. Imported weakness since then has - so far - helped to cool what appeared in the summer to be an overheating economy.

¶2. (SBU) With unpredictable externalities the rule of the day, Poles' assumptions about their own future are heavily caveated. Assuming no external or internal shocks that cause significantly deeper credit contraction, economic observers here predict GDP growth between zero and two percent in 2009 and unemployment rising moderately from its post-Communist low of 6.5 percent. The GoP is hunkered down, using the same fiscally conservative approach that has protected Poland's economy thus far to see it through the crisis and position Poland to quickly recover, if not shine, once the global economic storm has passed. End Summary.

Macro: Consumption Holds Up; Investment Motor Stalls
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¶3. (U) Private consumption has held up since the September collapse of Lehman Brothers, supported by higher incomes and stable, low unemployment. A rising real wage bill (up by 6.7 percent in Q4, according to preliminary GoP estimates) and low unemployment (6.7 percent) supported strong Q4 private consumption growth (4.6 percent). Nonetheless, local economists expect rising unemployment and restricted consumer credit will take their toll on consumption, pushing it under 3 percent growth in 2009.

¶4. (U) Government consumption, after declining through the first half of 2008, picked up in the second half, boosting GDP by around one-half of a percentage point in Q4. The 2009 budget includes an increase of 1.5 percent. That number is overly optimistic, however. Lower than expected revenues,

institutional difficulties in speeding up EU-financed projects, tight bond markets, and a strong GoP commitment to restrain deficit growth will keep the GoP from meeting its spending target. Government spending will likely not drag or boost the economy significantly.

¶5. (SBU) The real drag on Polish growth has been a collapse in investment, traditionally the sector most sensitive to weakness. Investment in Poland grew by 16 and 24 percent in 2006 and 2007, adding 3.1 and 4.3 percentage points to GDP growth. In the final quarter of 2008, fixed investment stalled (up 3.5 percent), accounting for most of Poland's slower GDP growth. All of our contacts are bleak on the prospects for recovery in investment next year and predict a decline.

¶6. (U) Finally, both exports and imports are falling, only the second time since the collapse of the command economy that Polish exports have shrunk. (The first, in 1999, followed the 1998 Ruble Crisis.) Despite that, net exports were virtually unchanged at -2.3 percent in Q4. Poland's economy is less trade dependent than others in this region, muting the impact of weakening export markets on the overall economy. Exports' share of Polish GDP was 41 percent in 2007, compared to 80 percent each in Hungary and the Czech Republic. Additionally, the massive depreciation of the zloty since July (31 percent on the euro, 44 percent on the dollar) should stimulate marginally increased exports and lower imports in 2009.

What Are the Unseen/Unrealized Risks?

¶7. (SBU) As one American lawyer/investment advisor puts it, "I'd rather be in Poland than anywhere else right now." Nonetheless, he and others are thinking about the local risks that might undermine Poland's resistance to the global crisis.

¶8. (SBU) Our best/smartest contacts tell us that their biggest worry is pretty straightforward - any shock which contracts credit supply more than demand. For example, restricted credit would further slow the one motor pulling the Polish economy forward - private consumption. One specific scenario that concerns all of our contacts, to varying degrees, is that parent banks based in Rome, Frankfurt, or New York will begin to siphon capital from their healthy Polish subsidiaries. Further, Polish companies tend to rely on short-term financing. Should their banks find themselves short of capital, companies here could have difficulty rolling over their debt.

¶9. (SBU) Others worry that default in Ukraine or Russia could prove to be a contagion that investors, failing to differentiate between healthy and sick economies in the region, quickly spread through all of Central and Eastern Europe. That contagion would further damage investment, contract credit, and drive the zloty even lower.

¶10. (SBU) Significant, continuing depreciation of the zloty also carries risks, despite the marginal stimulus it should provide to net exports, by increasing the burden of foreign currency-denominated debt. While that problem is real for those who hold the debt, Polish companies and households as a whole remain relatively unleveraged.

¶11. (SBU) Zloty depreciation also exacerbates an emerging problem among Polish companies that, in the first half of the year, hedged against zloty appreciation. Rather than buying straightforward call options, some of those companies bought more complicated contracts which exposed them to risks in the event of zloty depreciation. The scope of this problem is not fully understood. It is reported widely in the press and has drawn attention and legislative proposals from

government. The economists and bankers we talk to, however, are sanguine about the problem and estimate total exposure to be on the order of a manageable USD 4 billion. Nonetheless, further zloty depreciation will exacerbate the problem.

The GoP's Response

¶12. (SBU) The government is responding to the external economic crisis with a mixture of more fiscal conservatism, creative debt management, labor market flexibility, and jawboning. PM Tusk has sided with the anti-stimulus crowd in the EU, while Tusk and his Finance Minister have been almost militant in their rejection of deficit-financed stimulus. That stand has opened the government up to attack by the opposition Law and Justice (PiS) party, an opening PiS is exploiting. Tusk and FinMin Rostowski learned at the hand of Balcerowicz that their conservative, fiscally prudent response is the right one. Moreover, Poland's resistance to the economic crisis thus far is a validation, in part, of conservative fiscal policies since 2005.

¶13. (SBU) Reinforcing their natural inclination is the worry - shared by bankers, economists, and civil servants in the Finance Ministry - that Poland has little or no room for deficit financing. Contacts in the Finance Ministry report weaker demand for Polish debt, forcing them to issue shorter-duration bonds at higher spreads on U.S Treasuries. Further, the 2009 budget's revenue projections look less and less realistic. The deficit through February was PLN 5.5 billion, of a projected PLN 18.2 billion for all of 2009. Poland will have to borrow more just to keep up.

¶14. (SBU) Instead, the government is seeking a mix of non-deficit remedies to stimulate the economy and mitigate the impact of weakness. It has pledged to speed its use in Poland of billions in EU funds, though it is not clear it has

the institutional capacity to do that. It is using facilities available from International Financial Institutions, like the World Bank, to take advantage of lower interest rates, and it is working in the labor-business-government "Tripartite Council" to blunt the impact of declining demand on unemployment.

¶15. (SBU) Finally, Poles believe their country is unfairly grouped with others as a "CEE economy" -- part of a region in crisis. The GoP is working hard to differentiate Poland from its more troubled neighbors. PM Tusk and FM Rostowski traveled to Davos in January with the message that "Poland is an island of stability". Central Bank Chairman Skrzypek has just returned from Washington with the same message. As the GoP works to maintain fiscal discipline, it may be working too to sharpen the distinction among CEE economies in the minds of outsiders to reduce the penalties it believes Poland is paying - depreciation, higher borrowing costs, investment flight - for being in the wrong neighborhood.

¶16. (SBU) To reinforce all of these efforts, PM Tusk has doubled-down on his pre-Lehman commitment to bring Poland into the eurozone. Aside from benefits euro adoption would bring in more certain economic times, adopting the euro today would the eliminate exchange rate uncertainty and zloty risk premia plaguing Poland as well as bolstering the government's effort to differentiate Poland from the weaker economies of the region. However, the euro accession process has become much less certain thanks to the crisis. Tusk's ability to achieve this goal remains in doubt, particularly if he lets the budget deficit exceed the EU's Maastricht criterion (three percent of GDP).

Comment

¶17. (SBU) Poland owes its resistance to global crisis, at

least somewhat, to the dumb luck of fortunate timing. Consumer credit is a post-2001 innovation here and, by the summer of 2008, had not had enough time to develop into a bubble. Similarly, the American and Western European banks that dominate the banking system continue to make record profits quarter after quarter by developing what remains a maturing market. They have had no need to assume the risk of poorly understood, US-originated CDOs (for example) in a search for higher returns. Finally, Poland's economic cycle was moving quickly towards a peak as Lehman collapsed, with record low unemployment and above-trend GDP growth driving up the wage bill and inflation. At the outset, at least, global weakness has relieved upside pressure that had gathered in the economy.

¶18. (SBU) As Louis Pasteur noted, however, fortune favors the prepared. The Civic Platform-led GoP can take some credit for Poland's resistance to crisis. It imposed a budgetary discipline in good times that reduced the public debt to 46 percent of GDP. Even before it took power, PO supplied the PiS government with its Finance Minister - Zyta Gilowska - who began fiscal consolidation following years of high deficits under the Democratic Left Alliance (SLD)-led government. To the extent that Poland remains vulnerable to negative investor sentiment and tight bond markets, the GoP conservative fiscal response makes sense.
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